Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:MCT:[redacted]:[redacted]:POSTF-148323-01
[redacted]

date: December 17, 2001

to: [redacted], Revenue Agent

thru: [redacted], Case Manager, Group [redacted]

from: Associate Area Counsel (CC:LM:MCT:[redacted]:[redacted])

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subject: [redacted]
I.R.C. § 461(h)- accrual, economic performance.
Treas. Reg. § 1.468B-3(c), transfer to a qualified settlement fund.
I.R.C. § 172(f)- legal fee/specified liability loss.

Although we continue to recommend the entry of a Court order dictating that none of the $[redacted] transferred to the QSF in the year [redacted] can be disbursed to pay attorney's fees and costs incurred, or to be incurred, in connection with the defense (including litigation or settlement) of the [redacted] claims, there is a provision in the final regulations that will protect the interests of the Internal Revenue Service even if such an order is not obtained.

Treas. Reg. §1.468B-3 provides as follows:

> (f) *Distributions to transferors*--(1) *In general.* A transferor must include in gross income any distribution (including a deemed distribution described in paragraph (f)(2) of this section) it receives from a qualified settlement fund. If property is distributed, the amount includible in gross income and the basis in that property, is the fair market value of the property on the date of the distribution.
>
> (2) *Deemed distributions*--(i) *Other liabilities.* If a qualified settlement fund makes a distribution on behalf of a transferor to a person that is not a claimant, or to a claimant to resolve or satisfy a liability of the transferor (or a related person) other than a liability described in §1.468B-1(c)(2) for which the fund was established, the distribution is deemed made by the fund to the transferor. The transferor, in turn, is deemed to have made a payment to the actual recipient.

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(ii) *Constructive receipt.* To the extent a transferor acquires a right to a refund or reversion described in paragraph (c)(2) of this section of all or a portion of the assets of a qualified settlement fund subsequent to the transfer of those assets to the fund, the fund is deemed to distribute those assets to the transferor on the date the right is acquired.

(3) *Tax benefit rule.* A distribution described in paragraph (f)(1) or (f)(2) of this section is excluded from the gross income of a transferor to the extent provided by section 111(a).

The provisions of Treas. Reg. § 1.468B-3(f) will protect the Internal Revenue Service in the event that the QSF pays any accrued defense costs of [redacted]. If there is, in fact, a double-dip in the future, it can be caught and corrected in the future. Accordingly, while we still think that in an ideal world the deduction should be limited to funding which is clearly earmarked for allowable claims under Treas. Reg. § 1.468B-1(c)(2), since this is a case of an ambiguous order, the fisc will be protected if the deduction is allowed and the distributions from the QSF are audited.

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views. If you have any questions, please call [redacted] at [redacted].

[redacted]
Associate Area Counsel
(Large and Mid-Size Business)

By:____________________________
[redacted]
Senior Attorney (LMSB)

Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:MCT:[redacted]:[redacted]:POSTF-148323-01
[redacted]

date: December 14, 2001

to: [redacted], Revenue Agent

thru: [redacted], Case Manager, Group [redacted]

from: Associate Area Counsel (CC:LM:MCT:[redacted]:[redacted])

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subject: [redacted]
I.R.C. § 461(h)- accrual, economic performance.
Treas. Reg. § 1.468B-3(c), transfer to a qualified settlement fund.
I.R.C. § 172(f)- legal fee/specified liability loss.

We have received a response from the National Office on the requested post-review of our advice to you dated November 27, 2001. Although the National Office concurs with most of the advice given, there is a significant modification.

In the Answer to Issue 1, contained on page 2, we indicated that no deduction should be allowed for the $[redacted] of [redacted] legal fees unless and until [redacted] can establish (preferably by Court order) that these fees and costs cannot be paid from the Qualified Settlement Fund. However, there is no basis to disallow these fees once economic performance, by service, has occurred. Accordingly, the $[redacted] should be allowed as a deduction.

Nevertheless, there is still a significant and real concern about a potential double dip for the [redacted] legal fees deduction. This issue, however, is to be addressed as part of the evaluation of whether a deduction is permissible for the funding of the Qualified Settlement Fund ("QSF") and, if so, in what amount. To the extent that some of the funding transferred to the QSF will be, or could be, paid to cover legal fees and costs, there is a problem with allowing in full the claimed deduction for the funding of the QSF.[1] The potential problem arises from an ambiguity in the Court order establishing the QSF.

The regulatory background for the QSF must be analyzed to place this problem in context. Treas. Reg. § 1.468B-1(c), as relevant, provides as follows:

> (c) *Requirements.* A fund, account, or trust satisfies the requirements of this paragraph (c) if-
>
> (1) It is established pursuant to an order of, or is approved by, the United States, any state (including the District of Columbia), territory, possession, or political subdivision thereof, or any agency or instrumentality (including court of law) of any of the foregoing and is subject to the continuing jurisdiction of that governmental authority;
>
> (2) It is established to resolve or satisfy one or more contested or uncontested claims that have resulted or may result from an event (or related series of events) that has occurred and that has given rise to at least one claim asserting liability -
>
> * * * *
>
> (ii) *Arising out of a tort*, breach of contract, or violation of law; ..... and

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[1] We have limited our discussion to the potential problem with allowing a deduction for the $[redacted] of legal fees incurred prior to the bankruptcy filing since, due to the automatic stay prohibiting the continuance of any litigation or settlement of these claims, no additional legal fees for [redacted] defense have been incurred by the taxpayer. However, to the extent that legal fees are incurred in the future and these fees could be paid from the QSF, there is a theoretical potential that all monies transferred to the fund can be used to pay non-allowable claims, or at least some amount in excess of the $[redacted] which we are addressing herein. Moreover, as to the legal defense claims which will arise in the future, the all events test for accrual has not even been met since all events which establish the liability have not occurred. Accordingly, there is a potential that, depending upon the eventual plan of reorganization terms, the Service would be allowing a deduction for an event that is not even accruable prior to application of the economic performance requirement.

> (3) The fund, account, or trust is a trust under applicable state law, or its assets are otherwise segregated from other assets of the transferor (and related persons). (Emphasis added).

Treas. Reg. § 1.468B-1(h)(2) provides as follows:

> (2) *Classification of fund established to resolve or satisfy allowable and non-allowable claims.* If a fund, account, or trust is established to resolve or satisfy claims described in paragraph (c)(2) of this section as well as other types of claims (i.e., non-allowable claims) arising from the same event or related series of events, the fund is a qualified settlement fund. <u>However, under § 1.468B-3(c), economic performance does not occur with respect to transfers to the qualified settlement fund for non-allowable claims.</u> (Emphasis added).

The [redacted] legal fees are not claims "arising out of tort"[2], and thus are not claims defined in section 1.468B-1(c)(2); they are non-allowable claims. A reading of the Court order establishing the QSF indicates that it <u>may</u> be possible for these legal fee claims to be paid out of the fund as established. The Court order provides that the fund is established to pay Qualified Claims. Qualified Claims is defined in paragraph [redacted] of the order as follows:

[redacted]

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[2] See discussion of Issue One in our prior memorandum, at pages 10-11.

At a minimum, based upon our reading of the order, it appears that such claims for legal fees and costs may be made against the QSF unless the Court order establishing the QSF is clarified and states that no legal fees or costs incurred in defense of these claims will be paid out of the QSF[3].

Please note that the representative for the taxpayer disagrees that the order's language potentially authorizes the payment of non-allowable claims for legal fees and costs, pointing to the overriding caveat language in paragraph [redacted] of the Court order ("[redacted]"). The taxpayer argues that this shows the Court's intent to create a two-prong test, with both parts needing to be met before a claim can be paid: A) the claim has to within the enumerated classes; and B) it has to be a claim wholly described within section 1.468B-1(c)(2). Accordingly, the taxpayer's representative says that the defense legal fees can never be paid out of the QSF because said fees are not described in section 1.468B-1(c)(2).

Although the taxpayer's position on the interpretation of the order's language is appealing and persuasive, the ambiguity is created by the fact that the stated caveat (or the "second prong") is followed by the parenthetical ("Qualified Claims"). The parenthetical "Qualified Claims" follows not only the caveat but, more importantly, the enumeration of a list of claims which includes a category that could never possibly qualify as an

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[3] It is probable that plaintiff's attorneys' fees and costs will, in fact, be paid from the QSF since their payment will come out of the awards paid to the plaintiffs. But, technically, the payment will be to the plaintiff/victim recipients, and not directly to their attorneys. Simply because the plaintiff/victim recipients have their own contractual obligation to pay legal fees does not alter the fact that the QSF amounts paid to the plaintiffs arises out of a tort. Cf., Kenseth v. Commissioner, 114 T.C. 399 (2000), aff'd 2001-2 U.S.T.C. ¶ 50,570 (7th Cir. 2001); Sinyard v. Commissioner, T.C. Memo. 1998-364. But see, Estate of Clark v. United States, 202 F.3d 854 (6th Cir. 2000); Srivastava v. Commissioner, 2000-2 U.S.T.C. ¶ 50,597 (5th Cir. 2000), aff'g in part, and rev'g and remanding in part T.C. Memo. 1998-362. Moreover, even in the event that the plaintiff's attorneys are viewed as having their own property or independent claim to the funds to be received by them, under state law, the Service is still willing to treat payments to the plaintiff's attorneys as allowable claims against a QSF.

allowable claim against a QSF.[4] The insertion of this parenthetical may be taken to mean that the Court has already determined that legal fees and costs, including those for defense of the actions, <u>are</u> of a type of claim or class that is included in the claims which can, in fact, be paid from the QSF. In other words, it could be argued that the order has already determined that these costs are, generally if not to a specific claimant, of a type that is an allowable claim against this QSF. While this determination would not be binding on the Internal Revenue Service, which was not a party to the proceeding to establish the QSF, it creates the potential for such claims to be made, and paid, from the QSF. The Internal Revenue Service cannot be in a position of monitoring all payments from the QSF and claims made against the QSF, to see if transfers to the QSF were, in fact, for allowable claims. Moreover, if the deduction is allowed while this ambiguity in the Court order remains, the statute of limitations may bar disallowance of the QSF funding in the future when, and if, it is finally known that such non-allowable claims are being paid out of the QSF. Accordingly, so long as the potential exists that non-allowable claims can be paid from the QSF, the argument can be made that a deduction should not be allowed for the funding, at least to the extent of the $[redacted] potential non-allowable claims known at this time.

Please note that the fact that the Court order establishing the QSF is ambiguous, and may result in payment of non-allowable claims in fact (regardless of the caveat in the order stating that only claims described in section 1.468B-1(c)(2) of the Treasury Regulations will be resolved), does not serve to disqualify the QSF. The QSF is properly established. It is just not clear how much, if any, of the funding is deductible.

In other words, while the ambiguity in the order does not disqualify the fund, the ambiguity does give the Internal Revenue Service reason to disallow $[redacted] of the transfer in the year [redacted] since, as the order stands, these non-allowable claims may be paid from the fund. Economic performance does not occur with respect to the transfer to the QSF in the amount of

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[4] Paragraph [redacted] of the Court order also contains the following statement: "[redacted]." This sentence also highlights the ambiguity of the Court order, particularly since it is likely that the insurance coverage includes reimbursement of legal fees and costs incurred in defense and/or settlement of the claims.

$[redacted], and no deduction is allowed under Treas. Reg. § 1.468B-3(c)(1) to that extent.

If an order is entered dictating that none of the $[redacted] transferred to the QSF in the year [redacted] can be disbursed to pay attorney's fees and costs incurred, or to be incurred, in connection with the defense (including litigation or settlement) of the [redacted] claims, then any potential for payment of non-allowable claims from the QSF should be removed and a deduction of the full amount of the funding would be permissible.

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views. If you have any questions, please call [redacted] at [redacted].

[redacted]
Associate Area Counsel
(Large and Mid-Size Business)

By:________________________________
[redacted]
Senior Attorney (LMSB)

Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:MCT:[redacted]:[redacted]:POSTF-148323-01
[redacted]

date: November 27, 2001

to: [redacted], Revenue Agent

thru: [redacted], Case Manager, Group [redacted]

from: Associate Area Counsel (CC:LM:MCT:[redacted]:[redacted])

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subject: [redacted]
I.R.C. § 461(h)- accrual, economic performance.
Treas. Reg. § 1.468B-3(c), transfer to a qualified settlement fund.
I.R.C. § 172(f)- legal fee/specified liability loss.

This is in response to your request for advice received in this office on August 27, 2001. This memorandum should not be cited as precedent. This memorandum is subject to 10-day post review by our National Office and, therefore, is subject to modification. Please call our office at the end of this 10-day period to see if the advice has been accepted. Since this advice is subject to post review, please do not disclose the conclusions reached in this advice to the taxpayer until after the period for post review has expired. This discretion will prevent any misunderstandings in the event that the advice is modified in any manner by the National Office. Finally, in no event should a copy of this advice be provided to the taxpayer.

ISSUES

1. May an accrual-method taxpayer currently deduct legal fees ($[redacted]) and trade debts ($[redacted]) incurred prior to filing bankruptcy when actual payment of said liabilities will not be made within eight and one-half months of the close of the taxable year or, in fact, when actual payment in full may never be made depending upon the bankruptcy reorganization?

2. For the tax year ended [redacted], is a taxpayer in a Chapter 11 bankruptcy case entitled to claim a deduction for a [redacted] transfer into a segregated fund, established pursuant to a Bankruptcy Court Order as a "QSF", when there has been no confirmed plan of reorganization as of this date?

3. Do legal fees incurred to defend and/or settle [redacted] claims generate a specified liability loss within the meaning of I.R.C. § 172(f)?

ANSWERS

1. As to the legal fees and most trade debts, economic performance occurred and the liabilities are properly accrued. However, there are two caveats. First, as to any of the "trade debts" that were actually tax debts, economic performance may not have occurred, pursuant to Treas. Reg. § 1.461-4(g)(6)(i), and accrual would be improper. Additional facts will have to be reviewed in regard to the accrual of tax liabilities. Second, no deduction should be allowed for the legal fees and costs unless and until [redacted] can establish (preferably by Court order) that these fees and costs cannot be paid from the Qualified Settlement Fund.

2. Yes. The Bankruptcy Court Order establishing a segregated fund devoted solely to the [redacted] claimants (and costs), with no possible reversionary interest or benefit to the debtor, is sufficient to establish a qualified settlement fund (QSF) within the meaning of Treas. Reg. § 1.468B-1(c). It does not matter that there is not, as of yet, a confirmed plan of reorganization. Accordingly, transfers made to the fund by the debtor are properly deducted as accrued in the year of the transfer. Treas. Reg. § 1.468B-3(c)(1).

3. Yes, these costs are within the plain meaning of I.R.C. § 172(f)(1)(A)(ii).

BACKGROUND FACTS

On [redacted], [redacted] filed a voluntary petition under Chapter 11 of the Bankruptcy Code in the United States Bankruptcy Court for the [redacted]. The bankruptcy case is ongoing as a reorganization, with [redacted] operating as a debtor-in-possession, and no plan of reorganization has been confirmed.

The filing of the bankruptcy was precipitated by the [redacted] claims filed against [redacted]. The cost of settling present and future [redacted] claims [redacted]. It has been represented that, prior to filing bankruptcy, the taxpayer had paid [redacted] claims. At the time of the bankruptcy filing, there were in excess of [redacted] open [redacted] claims collectively alleging [redacted] of dollars in damages from alleged [redacted]. [redacted].

The [redacted] shareholders of [redacted] are [redacted].

At this time, it is estimated that plan confirmation is, at least, one year away. The taxpayer does not expect to file a plan of reorganization until late [redacted]. An officer of [redacted] indicated that there were three distinct problems in the reorganization that were being worked on: asset definition; liability definition; and, finally, the establishment of criteria and procedures to guide how much of the settlement fund proceeds will be paid to whom, and when said payments will be made.

The negotiations by [redacted] are an attempt to finalize what assets will be available to fund the bankruptcy plan. The assets of [redacted] primarily consisted of [redacted] How much [redacted] will contribute depends upon the ongoing negotiations discussed above.

There is also an ongoing attempt to define what liabilities must be addressed in the bankruptcy. There are the normal prepetition trade creditors, as well as the attorneys' fees and costs associated with the [redacted] litigation. Additionally, there are two segments of the [redacted] claims: the segment supported by existing claims and/or lawsuits and the segment representing the potential future claims. There must be an expert, and negotiations, for the parties to determine what amount should be recognized and provided for in anticipation of claims to be made in the future. This process is also ongoing.

Finally, the goal of the reorganization is to create a "final trust", with governing rules to follow when determining both how much of the proceeds a particular claimant is to receive and when the distributions are to be made. [redacted].

The taxpayer uses the accrual method of accounting, and is a calendar year taxpayer.

As stated above, when [redacted] filed bankruptcy, it had as an asset $[redacted] liabilities. During the bankruptcy, over $[redacted] of the [redacted] have been paid to [redacted], as debtor-in-possession, approximately $[redacted] in [redacted] and $[redacted] in [redacted]. [redacted] reported the $[redacted] in its income for the year [redacted], and will report as income the $[redacted] received for the year [redacted].

On or about [redacted], [redacted] filed a motion in the Bankruptcy Court, seeking a court order to establish a qualified settlement fund. It is alleged in the motion that, prior to the bankruptcy filing, the debtor expended $[redacted]. Prior to filing bankruptcy, [redacted] included the [redacted] received in income, and then took corresponding deductions when the [redacted]. Accordingly, there was no tax burden.

However, once [redacted] filed bankruptcy, it could no longer disburse [redacted] when received on the [redacted] injury claims. ([redacted] under prior agreements with [redacted], is still receiving the [redacted] during the bankruptcy case.)[1] Since the monies could not be disbursed, it was alleged in the motion that [redacted]

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[1] A note to the financial statement for [redacted] indicates that a court order was entered in the bankruptcy which prohibits the debtor from using any [redacted] related to [redacted] claims, including proceeds received and not used to settle [redacted] claims and costs prior to the bankruptcy petition date, in the ordinary course of business.

would incur a large tax liability because it would have to include the [redacted] in income, without any corresponding deductions, since there could be no "economic performance" under I.R.C. § 461(h). Accordingly, the debtor asked for entry of an order establishing a "qualified settlement fund" pursuant to I.R.C. §468B, and the regulations thereunder, into which the [redacted] could be deposited and maintained pending confirmation of a plan of reorganization.

On [redacted], an [redacted] was entered. The Order directed the debtor to "establish a separate escrow account that is a 'qualified settlement fund' under and pursuant to Internal Revenue Code Section 468B, and the regulations promulgated thereunder at Treas. Reg. § 1.147B-1,2, 3 and 4" (hereinafter the "Fund"). The Fund was segregated, and the debtor was permitted to deposit [redacted] received with respect to Qualified Claims.[2]

The proceeds in the Fund can be invested, and reinvested, in certain identified "safe" investments, and can be used to pay reasonable expenses of administering the Fund. However, no other disbursements can be made without court order. The order provides that the Court may enter order(s) directing distribution of the sums in the Fund whether in connection with confirmation of a plan of reorganization or, if no such plan is confirmed, then at such time as the Court deems it appropriate to authorize said distributions. The Order provides that in no event will any of

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[2] Qualified Claims is defined in paragraph [redacted] of the Order as follows:

[redacted]

the sums in the Fund be refunded or revert back to the debtor or any related entity, or be used for distribution to any creditors of the debtor other than those asserting Qualified Claims. Further, the Order provides that, if the Fund cannot be exhausted by paying Qualified Claims, [redacted]. Finally, the Court retained jurisdiction over the Fund until such time that all funds in the Fund have been disbursed in accordance with the orders of the Court.

Pursuant to the [redacted] Order, the debtor transferred $[redacted] of cash, consisting of [redacted], into the QSF prior to [redacted]. It has been represented to the I.R.S. that it was [redacted]'s practice to [redacted]. The [redacted] were only received by [redacted] after the claim was resolved. Based on this representation, it is assumed that the [redacted] deposited in the Fund do not represent claims which are in dispute.

[redacted] claimed a deduction of $[redacted], for the year [redacted], for the transfer to the QSF. Further, it is our understanding that the debtor is seeking court approval to add the additional $[redacted] of [redacted] received in the year [redacted] to the QSF. Accordingly, the QSF issue is a continuing issue which will impact the [redacted] tax year.

Finally, on its income tax return for the year [redacted], [redacted] showed a net operating loss of $[redacted] which it carried back ten years pursuant to I.R.C. 172(f). [redacted] states that its specified liability loss for [redacted] was $[redacted], consisting of the following: $[redacted] for payments in connection with [redacted] claims, litigation and settlements; $[redacted] of [redacted] legal expenses which were incurred, but not paid; and the $[redacted] contribution to the QSF. Based on the carryback of the loss from the year [redacted], claims for refund were filed on Forms 1139 and refunds were made for the following tax years: $[redacted] for [redacted]; $[redacted] for [redacted]; $[redacted] for [redacted]; $[redacted] for [redacted]; and $[redacted] for [redacted].

DISCUSSION

A. Accrual and Economic Performance.

On the return filed for the year ended [redacted], [redacted] claimed a deduction of $[redacted] for legal expenses paid in connection with the litigation and settlement of [redacted] claims.[3] The services were performed and the costs expended by the litigation firms. [redacted] did not pay these fees and costs, and the bills cannot be paid due to the filing of the bankruptcy case. These are general, unsecured prepetition claims which cannot be paid until there is a confirmed plan of reorganization.[4]

In the same category as the legal expenses are "other expenses" claimed of $[redacted], which consist primarily of trade creditors. It is our understanding that the trade creditors have either provided services, or provided goods, reflected in the billings. However, a cursory review of the ledger details of the "trade creditors" indicates that some portion of the $[redacted] was paid to taxing authorities, but it is not clear what taxes were covered by the payments (e.g., $[redacted]; $[redacted]; $[redacted]).[5]

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[3] Accountants for [redacted] have represented that none of these $[redacted] of attorneys' fees and costs will be paid from the "QSF". However, it seems as if these claims would constitute "Qualified Claims" as defined in the court order establishing the Fund, and would be entitled to receive distribution from the Fund eventually.

[4] This memorandum generally assumes that [redacted] will be successful in its reorganization attempts, insofar as it is assumed that a plan of reorganization will eventually be confirmed. However, if the reorganization is unsuccessful, it is likely that a Chapter 7 liquidation will follow. In the event of a liquidation, these general unsecured claims would not be paid until all assets are administered and a final distribution is approved by the Court. The general unsecured claimants will be in a position to receive even less in a liquidation, and may not receive any distribution at all.

[5] There are other de minimus amounts but, significantly, there is a $[redacted] payment to [redacted]. Please determine whether that payment could be in the nature of a tax payment.

An accrual method taxpayer is entitled to deduct an ordinary and necessary business expense in the year in which it is incurred, section 162(a), regardless of when it is actually paid. The test for determining when an expense is to be regarded as incurred by a taxpayer using an accrual method is three-fold:

1. Have all the events which establish the fact of the liability occurred,

2. Can the amount of the liability be determined with reasonable accuracy, and

3. Has there been economic performance under I.R.C. 461(h)?

I.R.C. §461(a), (h); Treas. Reg. § 1.461-1(a)(2)(i).

The agent does not dispute that the taxpayer has established that all events have occurred to establish the fact of the liabilities, and also that the amount of the liabilities can be determined with reasonable accuracy. The agent simply questions whether economic performance, as required under I.R.C. § 461(h), has occurred. The expenses were not paid within eight and one-half months of the bankruptcy filing, and may in fact never be paid, depending upon the outcome of the bankruptcy reorganization.

I.R.C. § 461(h)(2), in relevant part, provides:

(h)(2) **Time when economic performance occurs**

Except as provided in regulations prescribed by the Secretary, the time when economic performance occurs shall be determined under the following principles:

(h)(2)(A) **Services and property provided to the taxpayer**

If the liability of the taxpayer arises out of—

(i) the providing of services to the taxpayer by another person, economic performance occurs as such person provides such services,

(ii) the providing of property to the taxpayer by another person, the economic performance occurs as the person provides such property,

(iii) the use of property by the taxpayer, economic performance occurs as the taxpayer uses such property.

* * * * * * * * * *

(h)(2)(C) **Workers compensation and tort liabilities of the taxpayer**

If the liability of the taxpayer requires a payment to another person and ---

(i) arises under any workers compensation act, or

(ii) arises out of any tort,

economic performance occurs as the payments to such person are made. Subparagraphs (A) and (B) shall not apply to any liability described in the preceding sentence.

[redacted] asserts that it is permitted to claim deductions for the legal expenses and trade creditors because, pursuant to I.R.C. § 461(h)(2)(A), economic performance occurred when the services were performed for the debtor, or occurred when the property was provided to the debtor. This position is consistent with Treas. Reg. § 1.461-4(d)(2) which provides, in general, that economic performance occurs as services or property are provided to the taxpayer.

For the most part, we agree with [redacted]. Under the statute, economic performance did occur, with one apparent exception. To the extent that some of the claimed "accrued" expenses were for taxes, the general rule is that there is no economic performance until the taxes are in fact paid. Treas. Reg. § 1.461-4(g)(6)(i). As always, there are some exceptions to this rule (i.e., real property taxes if a valid election under section 461(c) made, certain foreign taxes, possible recurring items election[6]). Therefore, we suggest the development of further information concerning the nature of the taxes which the taxpayer has "accrued" but not paid, and a review of the provisions of Treas. Reg. § 1.461-4(g)(6) in connection with those accruals. It is likely that most, if not all, of the accrued taxes were improperly accrued.

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[6] It is our understanding that [redacted] has not adopted the recurring item exception method of accounting, authorized in section 461(h)(3) and described in Treas. Reg. § 1.461-5(d), for any item. The agent may want to verify this if the adoption of such a method would allow the accrual of taxes in this case.

As to the attorneys' fees and costs, economic performance occurred because the services were provided to the taxpayer. I.R.C. § 461(h)(2)(A)(i).

Please note that the "tort" exception to the economic performance rules is inapplicable as to the attorneys' fees and costs. Under section 461(h)(2)(C), if the liability of the taxpayer requiring payment to another person "arises out of any tort", then economic performance does not occur until payment is made to that person.[7] However, although the legal services related to the negotiation, settlement, or litigation of [redacted] personal injury claims, or "tort" claims, we do not believe that the legal expenses are properly viewed as "arising out of" any tort. Accordingly, actual payment is not necessary for economic performance. [redacted]'s liabilities running to the attorneys stem from [redacted]'s contract with the attorneys and not from the "tort".[8] The only payments which are

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[7] [redacted]. Therefore, it is clear that, at least as to the payments to be made to the ultimate victims, accrual is controlled by actual payment under I.R.C. § 461(h)(2)(C).

[8] Although the below-quoted case concerned the specified liability loss provisions under I.R.C. § 172(f)(1)(B), the discussion of the Ninth Circuit of the term "a liability arising out of a Federal or State law" is instructive:

> It is, therefore, not simply an expense incurred with respect to an obligation under federal law but an act "giving rise" to the liability that qualifies as a specified liability under the statute. The act giving rise to each of the liabilities in question was the contractual act by which Sealy engaged lawyers or accountants. In each of these instances the act did not occur at least three years before the beginning of the taxable year.
>
> Sealy's argument essentially is that the act giving rise to the liability is the first event in a chain of causes which gives rise to the liability. The argument leads to a reductio ad absurdum. The organization of the company gave rise to an obligation to comply with all pertinent state and federal laws and thereby gave

intended to be captured by the restriction in section 461(h)(2)(C)(ii) are the payments which are due to the "victims" or claimants and not the payments to the professionals who defended the claims.

Please note that the concern over the failure to make payment within eight and one-half months of the close of the tax year is misplaced. It is true that there is such a requirement under the certain recurring items exception found at I.R.C. § 461(h)(3). The recurring items exception allows the accrual of an expense if the all events test has been met, but the economic performance requirements of I.R.C. § 461(h)(1) have not been met. We have concluded that, except as noted above for possible tax expenditures, the economic performance requirement <u>has</u> been met. Accordingly, the recurring items exception, and the requirements thereunder, are not relevant to the determination that the items at issue were, for the most part, properly treated as incurred and accrued by the taxpayer. It does not matter if payment has been delayed indefinitely by the bankruptcy filing.

Finally, there is some concern that the claims may never in fact be paid, or will not be paid in full, due to the filing of the bankruptcy. The bankruptcy was filed prior to the close of the relevant tax period so, at the time that these expenses were accrued by the taxpayer, the possibility of nonpayment, or reduced payment, was known.

The law distinguishes among the different types of contingencies to which a liability may be subject and assigns a particular effect to a contingency, depending upon how it is categorized. Some contingencies are conditions precedent that prevent satisfaction of the "all events" test and accrual of the liability until the condition is resolved. Other contingencies are conditions subsequent that defease an accrued liability only if that contingency occurs.

Other types of contingencies do not prevent accrual because they are remote contingencies or because they are simply not recognized as preventing accrual. We believe that the contingency

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> rise to the liabilities incurred in complying with these laws. According to this logic, every corporation would have a specified liability carryback for all costs the corporation incurred to comply with relevant laws. Congress did not create such a windfall.
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> <u>Sealy Corp. v. Commissioner</u>, 171 F.3d 655, 657-658 (9th Cir. 1999).

of non-payment, or at least of non-payment in full, in this case is one of the contingencies that is not recognized as preventing accrual. As the Supreme Court noted in United States v. Hughes Properties, Inc., 476 U.S. 593, 605-606 (1986):

> There is always the possibility, of course, that a casino may go out of business, or surrender or lose its license or go into bankruptcy, with the result that the amount shown on the jackpot indicators would never be won by playing patrons. But this potential nonpayment of an incurred liability exists for every business that uses an accrual method, and it does not prevent accrual.

See also, Gold Coast Hotel & Casino v. United States, 158 F.3d 484 (9th Cir. 1998) (an accrual method casino could deduct the value of slot club points won by a club member for the year in which the member accumulated the minimum number of points necessary to redeem a prize; the casino's liability was not rendered conditional by the possibility that some of the points accumulated by members might go unredeemed); Helvering v. Russian Finance Construction Corp., 77 F.2d 324 (2d Cir. 1935)(where a contract had a fixed price component, due when ore was to be delivered, and royalties of $2 per ton were payable ten years after the agreement was signed, but subject to cancellation if one of three contingencies occurred, the liability to pay royalties arose upon delivery of the ore, and the contingencies were conditions subsequent). There is no need for certainty of payment to permit accrual of an item. Russian Finance Construc., 77 F.2d 324, 327.

In Southwestern States Marketing Corp., 179 B.R. 813, 95-1 U.S.T.C. ¶ 50,057 (N.D. Tx. 1994), aff'g an unreported bankruptcy decision, and aff'd in unpubl. opinion, 96-1 U.S.T.C. ¶50,165 (5th Cir. 1986), the debtor ("SWSM") operated between 1978 and 1981 as a reseller of crude oil. In 1982, SWSM was placed in an involuntary Chapter 11. In 1984, the Department of Energy filed a claim for violation of pricing regulations. In 1985, the case was converted to a Chapter 7 liquidation. In 1991, the Chapter 7 Trustee reached an agreement with DOE as to the amount of pricing overcharges, which required the debtor to return to DOE over $86,000,000 (which amount included pre- and post-petition interest). The Chapter 7 Trustee filed a tax return for 1991, claiming the $86,000,000 deduction, and carrying it back over several years to eliminate all prior tax liabilities. Suit was then filed to compel the I.R.S. to pay a refund in excess of $11,000,000.

The Bankruptcy Court, upheld by the District Court and Court of Appeals for the Fifth Circuit, denied the deduction based on the DOE liability, finding that the "all events" test had not been met since no likelihood of repayment existed.[9] Since there was no likelihood of repayment, the rule that allows accrual of a liability when there is merely a possibility of non-payment was not applicable. As stated by the District Court, "[w]hen there is no prospect of payment, the all events test has not been met because the liability is not fixed." 179 B.R. at 817.

The situation which we have in this case is not what was presented in Southwestern States Marketing. Even though [redacted] did in fact file bankruptcy in the same year that the expenses were incurred, it filed for a reorganization under Chapter 11. [redacted] still operates. There are ongoing negotiations regarding the proposed settlement funds and contributions from the shareholders of [redacted], as well as from [redacted]. Therefore, even though it is highly likely that the holders of general unsecured claims will not be paid [redacted]% of their claims, this is not a sufficient reason to say that the liability is not fixed. Here, although experience with other reorganization cases supports an argument that there is more than a possibility of non-payment, at least non-payment of the full amount, the facts in this case are not sufficient to deny accrual of the liabilities since this is not a case in which the non-payment is a certainty. See also, Cohen v. Commissioner, 21 T.C. 855 (1954), acq. 1954-2 C.B. 4; Southeastern Mail Transport v. Commissioner, T.C. Memo. 1992-252; cf., Matter of West Texas Marketing Corporation, 54 F.3d 1194 (1995)(liability for post-petition interest not established because, inter alia, the condition requiring the payment of interest - the existence of assets after payment of all claims - was *in futuro*).

Accordingly, except for the qualification discussed above for the accrual of any tax liabilities, we agree that, as a legal principle, [redacted] could properly accrue the legal fees and trade debts. However, there is a factual problem which may prevent allowing a deduction for the approximate $[redacted] of claimed legal fees since there is a potential "double-dip" in this case. As discussed more fully below, [redacted] is entitled to claim a deduction for monies transferred to the Qualified Settlement Fund. The claims that can be paid out of the QSF include litigation and settlement costs associated with the

[9] In Southwestern States Marketing, at all relevant times, SWSM was insolvent. The 1991 return only showed assets of $68,602.86 available to meet the DOE obligation. SWSM ceased operating in 1982, never resumed operating, and was in a liquidation. There was no possibility that the $86,000,000+ DOE claim was ever going to be paid.

[redacted] claims. The claims for costs which can be paid out of the QSF are the same as what is being claimed for accrual in the $[redacted]. While these attorney's fees and costs are "only" general unsecured claims in the bankruptcy, there is no reason to conclude that these very said claims cannot make a claim against the QSF. By allowing both a deduction for the accrued fees and the transfer to the QSF, there is a potential double-deduction for the same expense. Accordingly, [redacted] should not be allowed a separate deduction for these attorney's fees unless and until the taxpayer can establish (preferably by a Court order) that these general, unsecured claims cannot be paid from the QSF.

B. Qualified Settlement Fund.

When [redacted] filed bankruptcy, it had as an asset $[redacted]. During the bankruptcy, approximately $[redacted] of the [redacted] were paid to [redacted] as debtor-in-possession. As detailed in the facts above, pursuant to the [redacted] Order establishing a Qualified Settlement Fund[10], [redacted] transferred $[redacted] of [redacted] to the QSF and claimed a current deduction for the transfer. The debtor intends to make a similar transfer of [redacted], and claim a similar deduction, in the year [redacted].

[redacted] has liabilities from [redacted] claims, the total amount which is yet to be determined. The [redacted] are flowing in, but the [redacted] cannot be disbursed due to the bankruptcy. By establishing the trust, an "interim trust" in effect, [redacted] is able to make payments in partial settlement of what will be the overall liability which will be determined later. The transfers do not extinguish or resolve all of [redacted]'s liabilities, but are made in partial satisfaction of its liabilities, up to the amount transferred, since there is no reversionary interest in the QSF.

As discussed in section A above, an expense deduction is allowed only when economic performance has occurred with respect to the underlying liability. I.R.C. § 461(h)(1). Economic performance of a liability which requires payment to a person and arises out of any tort occurs as payments to such person are made.

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[10] A QSF is defined in Treas. Reg. §§ 1.468B-1 through 1.468B-5. These regulations were promulgated, pursuant to the authority and dictate of I.R.C. § 468(B)(g), so as to provide for the current taxation of escrow accounts, settlement funds, and other similar type arrangements as separate taxable entities.

I.R.C. § 461(h)(2)(C). However, Treas. Reg. § 1.468B-3(c)(1) provides the general rule that, for purposes of section 461(h), economic performance occurs with respect to a liability arising out of a tort to the extent the transferor makes a transfer to a qualified settlement fund (QSF) to resolve or satisfy the liability. Accordingly, a deduction for an accrual basis taxpayer is permitted at the time of the transfer to a QSF.[11]

As is relevant to this case, Treas. Reg. § 1.468B-1(c) provides that a fund or account will be a qualified settlement fund if it is:

1) Established pursuant to a court order;

2) Established to resolve or satisfy one or more contested or uncontested claims that have resulted or may result from an event (or related series of events) that has occurred and that has given rise to at least one claim asserting liability arising out of a tort; and

3) Segregated from other assets of the transferor and related persons.

The fund in this case was established by court order, and the fund is segregated. Further, the court order establishing the fund indicates that the sums in the fund shall be used solely to resolve claims described in Treas. Reg. § 1.468B-1(c)(2), and [redacted] does not have any reversionary interest in the fund.

While any confirmed plan of reorganization will address the specific rules necessary to administer and distribute the assets in the QSF, we do not believe that such governing criteria need to be in place in order to satisfy the requirement that the fund be established to resolve or satisfy the liability. Unlike under the statutory designated settlement fund, there is no need for the transfer to a QSF to extinguish or fully resolve or satisfy the transferor's liability. Although the regulations are not explicit on this issue, it is the Service's position that a pro tanto resolution or satisfaction meets the regulation standards for an

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[11] Treas. Reg. § 1.468B-3(d) provides that no deduction is allowed for a transfer to a qualified settlement fund to the extent that the transferred amounts represent insurance proceeds that are excludable from gross income. [redacted].

QSF. The QSF rules should be distinguished from the Designated Settlement Fund rules that appear in I.R.C. § 468B(a)-(f), which require that the fund extinguishes completely the transferor's liability. The QSF rules were designed to provide more flexibility. Thus, it is sufficient that the fund was established for the purpose of paying the [redacted] claimants, even if the there has not yet been a confirmed plan of reorganization directing the claimants to look to the fund. See, PLR 199949008 (September 3, 1999)(payments which company may have to make subsequent to bankruptcy plan confirmation, but prior to the bankruptcy plan effective date, to a Trust will be deductible under section 162 at the time the payment is made to the Trust, pursuant to section 461(f) and Treas. Reg. § 1.468B-1(c)(2)); PLR 9839027 (June 29, 1998)(on Date 1, Court preliminarily approved a settlement agreement, Date 2 a Fund was established with an initial payment to the Committee (with the funds being segregated), Date 3 the Court entered its final order approving the settlement, Date 4 the Fund was formally established as a trust under state laws, Date 5 the Court's order became final: held that the Fund constituted a qualified settlement fund since Date 2, and the initial payment made on Date 2 was deductible when made).

In this case, at the time of the transfer to the fund, there is a resolution of the liability to the extent of the amount of the monies transferred since the monies cannot revert back to the taxpayer nor can the monies be used to pay anybody other than [redacted] claimants and related costs.[12] That this may only be a partial resolution at the time of the transfer does not mean that the transfer was not made to resolve or satisfy the liability. See, Treas. Reg. § 1.468B-1(k), example 1 (fund to resolve a liability of $150 million is a QSF where only $125 million was transferred to the fund); § 1.468B-1(k), example 4 (defendant's partial deposits of amounts into a fund is treated as a QSF). But see, United States v. Douglas E. Brown, et. al., 2001-2 U.S.T.C. ¶ 50,519, 2001 U.S. Dist. LEXIS 8064 (Dist. Utah 2001)(special master's report), appeal pending (10th Circuit)(rejecting I.R.S. claim that fund was QSF, in part, because fund did not resolve or satisfy the liability, finding partial resolution to be insufficient).

It is concluded that the QSF established by the [redacted] order of the Bankruptcy Court satisfied the requirements of

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12 [redacted].

the regulations, and that [redacted] is entitled to deduct the monies transferred to said QSF as of the date of the transfer.

C. SPECIFIED LIABILITY LOSSES.

It is represented that, from [redacted] until [redacted] was engaged in the manufacturer of "[redacted]", a [redacted] product that contained [redacted]. Beginning in approximately [redacted] or [redacted], [redacted] products. The expenditures at issue relate to these liabilities.

I.R.C. § 172(b)(1)(C) provides that, the case of a taxpayer which has a specified liability loss for a taxable year, such specified liability loss shall be a net operating loss carryback to each of the 10 taxable years preceding the taxable year of such loss.

For the year [redacted] I.R.C. § 172(f), in relevant part, defines specified liability loss as follows:

> 172(f)(1) In General.---The term "specified liability loss" means the sum of the following amounts to the extent taken into account in computing the net operating loss for the taxable year:
>
> (A) Any amount allowable as a deduction under section 162 or 165 which is attributable to -
>
> (i) product liability, or
>
> (ii) expenses incurred in the investigation or settlement of, or opposition to, claims against the taxpayer on account of product liability.
>
> * * * * *
>
> (f)(2) Limitation.-- The amount of the specified liability loss for any taxable year shall not exceed the amount of the net operating loss for such taxable year.

Section 162(a) provides that there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. We believe that the expenses listed are ordinary and necessary business expenses that may be deducted, and we do not believe that the expenditures need to be capitalized.

I.R.C. § 461 states the rules for determining when the amount of any deduction shall be taken into account. As stated in section A above, the $[redacted] of [redacted] legal expenses, incurred but not paid, was properly deductible in the year [redacted]. The $[redacted] for payments made in connection with [redacted] claims, litigation and settlements was also properly deductible in the year [redacted]. The $[redacted], contributed to the QSF, was properly deductible in [redacted]. Accordingly, since the net operating loss of $[redacted] is less than the minimum amount of the alleged "specified liability losses" which would be currently deductible in [redacted] the only question is whether these expenditures are of a type described as "specified liability losses".

These expenditures qualify as specified liability losses as product liability costs under I.R.C. § 172(f)(1)(A). I.R.C. § 172(f)(4) defines "product liability" as follows:

> (A) liability of the taxpayer for damages on account of physical injury or emotional harm to individuals, or damage to or loss of the use of property, on account of any defect in any product which is manufactured, leased, or sold by the taxpayer, but only if
>
> (B) such injury, harm, or damage arises after the taxpayer has completed or terminated operations with respect to, and has relinquished possession of, such product.

Treas. Reg. § 1.172-13(b)(1) provides, in relevant part, that "the term "product liability loss" means, for any taxable year, the lesser of ----

> (i) The net operating loss for the current taxable year ...., or
>
> (ii) The total of the amounts allowable as deductions under 162 and 165 directly attributable to-
>
> > (A) Product liability (as defined in paragraph (b)(2) of this section), and
> >
> > (B) Expenses (including settlement payments) incurred in connection with the investigation or settlement of or opposition to claims

> against the taxpayer on account of alleged product liability.

Treas. Reg. § 1.172(b)(2)(i) provides that:

> The term "product liability" means the liability of the taxpayer for damages resulting from physical injury or emotional harm to individuals, or damage to or loss of the use of property, on account of any defect in any product which is manufactured, leased, or sold by the taxpayer. The preceding sentence applies only to the extent that the injury, harm, or damage occurs after the taxpayer has completed or terminated operations with respect to the product, including, but not limited to the manufacture, installation, delivery, or testing of the product, and has relinquished possession of such product.

The [redacted] claims being defended and settled by [redacted] meet the definition of "product liability" losses and constitute specified liability losses, to the extent of the net operating loss, for [redacted].

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views. If you have any questions, please call [redacted] at [redacted].

[redacted]
Associate Area Counsel
(Large and Mid-Size Business)

By:________________________
[redacted]
Senior Attorney (LMSB)